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The Case for Trade Liberalization in Developing Countries

Rudiger Dornbusch

In a broad swing of the pendulum, developing countries have been shifting from severe and destructive protection to free trade fever. Many of the notable examples are in Latin America. Mexico, after a major unilateral trade liberalization, is now negotiating a free trade agreement with Canada and the United States; Chile, traditionally a highly protected country, is a leading example of reducing trade barriers; Argentina and Brazil have entered free trade agreements. A free trade area for the Americas is becoming a serious possibility. The enthusiasm for more openness of the economy is not limited to Latin America; for example, Korea and Turkey are cases of highly successful liberalization. There are also cases in Africa—for example, Ghana and Botswana—to demonstrate the possibility and the benefits of opening up.

This new enthusiasm for freer trade stems from four overlapping sources:

Anti-statism. The world has seen a broad intellectual swing away from emphasizing the beneficial role of the state in the 1980s, and protection is seen as one of the manifestations of an overly intrusive state. Of course, a shift to a liberal trade regime has not always been the by-product of a more democratic society: Chile under Pinochet or Korea in its liberalizing phase were under authoritarian rule. “Two cheers for the market, but not three,” the saying goes; today the market gets at least three cheers, which may be at least one too many.

Poor economic performance. Many developing countries have suffered dismal economic performance and declining productive potential. Much of the reason can be traced to populist macroeconomic policies that engendered debt crises and hyperinflation. Of course, part of the reason was also a very adverse external environment. But since the days of plentiful external credit are gone,

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attention must shift to productivity gains as the source of growth. Trade may offer part of the solution.

Information. Citizens worldwide are exposed to more information about the opportunities available in other countries. It is no longer possible to conceal that goods in a country cost three or four times the world price or that they are not available. The elite want their BMWs, almost as a civil right; and the poor want cheap food and low cost consumer durables that are available in world markets; firms know what technologies and inputs their competitors abroad can use and insist on the same access. It is no longer possible to assert that liberal trade policy must immiserize a country; on the contrary, many economic actors now see access to imports as a way of stretching their buying power.

World Bank pressure and evidence of success. Major research projects under the auspices of the NBER and the World Bank have documented the problems of inward-looking trade strategies and discerned the lessons from successful trade strategies (Balassa, 1989; Bhagwati, 1978; Bruton, 1989; Krueger, 1978, 1990; Pack, 1988; Michaely et al. 1991; Thomas and Nash, 1991a, b). The research helped diffuse the black-and-white debate—free trade versus protection—to reach a more differentiated judgment involving the importance of neutral trade regimes as opposed to regimes that are biased against exports. The favorable performance of countries which adopted outward-oriented policies served to make trade liberalization, broadly understood, a central condition for World Bank lending.¹

This paper next reviews the actual situation of protection in developing countries, to set the stage for a discussion of the prospective gains from liberalization. Three experiences with liberalization are then briefly sketched and the question is raised as to what can go wrong. The paper concludes by taking up two directions in which liberalization is now moving, regional free trade zones and liberalization of trade in services.

Protection in Developing Countries

Protection became the mode for most developing countries during the 1930s. During the Depression, industrial countries adopted restrictive trade policies and commodity prices—a major source of earnings for developing countries—collapsed. Debt service problems loomed, as discussed by Eichengreen in the Spring 1991 issue of this journal. The pursuit of a policy of

¹These factors apply even more forcefully to Eastern Europe and the Soviet Union. As these economies shed central planning, a wide-open trade regime is seen as a critical measure. Nothing could more dramatize the belief in the promises of openness than the advice to drop from one day to the next all and any obstacles to international trade (Sachs, 1991; Dornbusch, 1991). Nor could any policy have a more drastic immediate effect; when East Germany liberalized totally in its union with West Germany, industrial production fell within a year by 50 percent and unemployment skyrocketed.

industrialization behind protective walls of tariffs and import quotas took hold first as a means of saving foreign exchange for debt payments, and then became viewed as a development strategy. The strategy was predicated on the assumption that primary producing countries would face inevitably a deterioration of the terms of trade; growth in demand for primary commodities was believed to be small because of low income elasticities for commodities and ongoing substitution toward alternative materials. At the same time, high rates of technical progress on the supply side would create a situation of excess supply and declining relative prices.

Trade policy changed little in the period immediately after World War II. Industrial countries continued for some time with highly restrictive trade policies, while many developing countries did not face foreign exchange problems due to their accumulation of foreign exchange reserves during wartime and a subsequent boom in commodity prices during the Korean war. But then commodity prices collapsed again, and developing countries faced stark questions of the appropriate trade and exchange policies. As industrial countries moved gradually in the direction of trade liberalization and currency convertibility, should the developing world follow?

The prevailing view, especially in Latin America, was the doctrine from the United Nations Economic Commission for Latin America, more commonly known as ECLA. In this view, developing countries should pursue an import substitution industrialization strategy to avoid the problem of secularly deteriorating terms of trade (Prebisch, 1959, 1984). Import substitution meant the development of domestic industry behind a high protective barrier of tariffs, quotas and licences. That policy was pursued vigorously. Direct foreign investment helped industrialization proceed, in some cases with extraordinary success, as in Brazil.

There was an intellectual counter-current supporting the classical case for free trade, notably in Jacob Viner's (1952) *Rio de Janeiro Lectures* and Gottfried Haberler's (1959) *Cairo lectures* (Meier, 1963). The debate carried into the 1960s when the protection doctrine became the main fare in the newly formed UN Conference on Trade and Development (UNCTAD), the intellectual forum in which developing countries shaped their views on trade and development strategy. Interestingly, while major progress was made in trade liberalization among industrial countries under the GATT, that same GATT allows developing countries substantial leeway in maintaining trade protection (Finger, 1991). This seems peculiar today, since poor countries especially ought to focus on making the best of their resources, but it fit the prevailing ECLA doctrine that protection was a pathway to development.

In the late 1960s and 1970s, protection in developing countries softened in at least one direction. Many countries recognized that protection by tariffs and quotas did keep imports out, but that the resulting decline in demand for foreign exchange also led to an appreciation of the currency and hence a severe tax on exports of both traditional commodities and emerging industrial goods.

Unstable real exchange rates added to the hazards of export activities. Moreover, duties on imported intermediate goods first implied a tax on export activities using these goods, and then helped cause a currency overvaluation which hurt export competitiveness of these products.

From an industrialization standpoint it made sense to avoid the anti-export implications of protectionist policies by reducing duties and pursuing policies for stable exchange rates. The NBER studies mentioned earlier document that countries which adopted outward-oriented policies, at least to the extent of neutralizing anti-export bias, performed better than countries who failed to recognize the adverse effects of restrictions on their export potential.

It would be natural at this stage to offer a measure of the restrictiveness of the trade regime of various countries, and perhaps a time series portraying a protectionism index for developing countries. But even with great heroism, it is at best possible to create subjective, qualitative indices for individual countries.

Difficulties emerge from at least five sources. First, even if only tariffs were used, rates of duty differ widely across commodities. Hence one could measure at best weighted averages, but these may give a poor idea of the marginal protective effect of a tariff structure. Because of differing elasticities of demand and supply across goods, aggregate duty rates or total tariff revenue as a percent of sales are a poor measure of restrictiveness. Second, in the presence of intermediate goods the protective effect of a tariff structure depends on tariff rates on final goods relative to those on intermediate inputs. When intermediate goods enjoy lower tariff rates than final goods, as is usually the case, effective rates of protection can exceed statutory rates by a multiple.

Third, tariffs are not the only intervention by which trade might be hampered. The flora of common nontariff trade barriers include restrictive licenses; quotas; outright prohibitions; impediments to foreign exchange transactions (including required advance deposits for such transactions); customs valuation impediments, and more. Quantifying the effects of such restrictions on a common scale is even more difficult.

Fourth, the welfare cost of tariff rates and other impediments to trade depends on general equilibrium effects and market structure. For example, if substitution possibilities are moderate, then the welfare costs of distortions will be small. Similarly, restricted trade leads to imperfect competition, which may impose substantial economic costs.

Finally, restrictions on imports of one kind or another limit the quality, variety and the availability of technology.

While it is impossible to find a single representative number characterizing the restrictiveness of a trade regime, it is still possible to get an impression. An attempt to measure effective tariff rates, making appropriate adjustments for nontariff duties, has been made for the mid-1980s by Erzan and Kuwahara (1989). Table 1 presents some of their results. The first two columns show the effective tariff rates for various regions of the world on all sectors and on manufactures, while the third column shows that nontariff barriers are

Table 1

Protection in a Sample of 50 Developing Countries

	Tariff Rate ^a		Non-Tariff Measures ^b
	All Sectors	Manufactures	
Caribbean	17	20	23
C. America	66	71	100
S. America	51	55	60
N. Africa	39	45	85
Other Africa	36	37	86
W. Asia	5	6	11
Other Asia	25	27	21

Source: Erzan and Kuwahara (1989)

^aPercent ad valorem tariff

^bPercent of tariff positions covered by nontariff barriers

sometimes responsible for at least half of the protectionism impact. The table brings out that South and Central America and North Africa have had particularly high average tariff rates, and even more so in manufacturing. Within manufacturing, Erzan and Kuwahara also found that machinery and equipment receives significantly lower tariff rates than other manufactured goods.

More recently, many developing countries have gone beyond compensation for anti-export bias to more radical reform. Quotas are being turned into tariffs, tariffs are being more tightly focused, and tariff rates are being reduced. Invariably, trade policy reform has also been part of a much broader program of policy reform including domestic stabilization and deregulation. Readers interested in the diverse experiences of many nations with such reforms might consult Papageorgiou, Choksi and Michaely (1990), Michaely, Choksi and Papageorgiou (1991), Thomas and Nash (1991b), Shepherd and Langoni (1991), Whalley (1989) and World Bank (1987, 1988).

Gains from Liberalization

Measuring the benefits of trade reform has been a frustrating endeavor. Although the discussion of trade policy at times gives the impression that a liberal trade regime can do wonders for a country's economy, and most observers believe firmly that trade reform is beneficial, yet systematic attempts at quantification fail to single out trade policy as a major factor in economic growth. But then, of course, growth accounting has not come up with a satisfactory explanation for the residual which may be as much as 30 to 50 percent of growth. The channels through which trade liberalization could bring benefits are broadly these: improved resource allocation in line with social

marginal costs and benefits; access to better technologies, inputs and intermediate goods; an economy better able to take advantage of economies of scale and scope; greater domestic competition; availability of favorable growth externalities, like the transfer of know-how; and a shakeup of industry that may create a Schumpeterian environment especially conducive to growth. This section will comment on each of these factors.

The static gains from improved resource allocation are the classical source of a gain from freer trade. Under perfect competition a small, price-taking country will gain by eliminating tariffs. Consumers are better off because their incomes stretch further, and resources are used more efficiently because they are no longer used to produce goods that could be imported at a lower price. As one early example of measuring these potential gains, Harberger (1959) estimated the welfare cost of protection in Chile to amount to 2.5 percent of GNP, as opposed to 10 percent for domestic distortions.²

While the traditional discussion often focuses on final, homogeneous goods, the case for freer trade is enriched by including the facts that trade liberalization increases the variety of goods, and raises productivity by providing less expensive or higher quality intermediate goods. This aspect has been explored in some recent models of growth; for example, Romer (1989) emphasizes both the productivity of specialized resources and the limitations given by the size of the market. In a restricted economy, only a narrow range of specialized intermediate goods or capital goods can be profitably produced and therefore the full range of technological possibilities, which rely on a potentially broader range of inputs, cannot be exploited effectively. In this model, a greater variety of inputs does more for production than a greater quantity of a narrow range of inputs. Thus, access to a variety of foreign inputs at a lower cost shifts the economy-wide production function outward, which illustrates a concrete link between productivity and the trade regime.

The availability of imported intermediate goods and of technology, whether licensed or embodied in imported capital goods, is an important additional source of gain in shedding a restrictive trade system. If foreign exchange restrictions, for example, make it impossible to use a superior process, resources are wasted. They are similarly wasted if duties or prohibitions foreclose the import of key intermediate goods that may be extravagantly expensive or impossible to produce locally. If appropriate intermediate goods can be imported, a country may easily become an exporter of labor intensive tasks such as assembly services; without such imports, that value-added opportunity is lost, along with the opportunity to graduate over time from assembly to tasks with higher value-added.

It is a well-known proposition that reducing certain tariffs, as opposed to eliminating all of them, is a more delicate issue. A partial tariff reduction is a second-best exercise, so welfare need not necessarily improve. However, it will

²These are the famous Harberger "triangles." See Harberger (1959).

generally be true that an equiproportionate cut in tariff rates will raise welfare. For more complicated situations of partial liberalization, computable general equilibrium models can (at least in principle) offer an answer as to the welfare effects.

Free trade leads to a more economically rational market structure. Gains from liberalization also result from scale economies and economies of scope that arise in wider markets. Moreover, markets in protected economies are narrow and lack of competitors from the rest of the world fosters oligopoly and inefficiency. Protectionism can create market power for domestic firms, where under free trade there would be none.³ The casual evidence of these effects is striking. For example, when Mexico liberalized, firms put under pressure by import competition rationalized their activities to the point that they became export competitive. In fact, they looked to export markets to achieve a scale that would allow them to be competitive. Particularly in small countries where imports are restricted, quality is exceptionally low and variety falls far short of what is available in the world market. And prices are, of course, far above the world market, the more so the smaller and more protected the country.

An open trading environment is also associated with a transfer of know-how. Much is made, rightly, of the transfer of knowledge virtually by osmosis. Haberler (1988, p. 29) made the point this way:

What J. S. Mill said 100 years ago is still substantially true. "It is hardly possible to overrate the value in the present low state of human improvement, of placing human beings in contact with persons dissimilar to themselves, and with modes of thought and action unlike those with which they are familiar. Such communication has always been, peculiarly in the present age, one of the primary sources of progress."

A similar argument underlies the discussion of the convergence of growth rates among countries in the world economy, as in Baumol et al. (1989) and the literature reviewed in Edwards (1991). However, the force of the Mill-Haberler argument is lessened once protectionism is taken into account. Multinationals can bring direct foreign investment, technology and knowledge, but under the cover of tariffs and quotas they may not do their best. Thus, today in Argentina, the 1964 Ford Falcon is still being produced with the U.S. machinery of that time, without model change, as if the clock had stopped.

Beyond the general benefit of exposure to an advanced, competitive world market, the act of trade liberalization also carries the potential of dynamic benefits. In their systematic study of industrialization and development, Chenery et al. (1986) focused on the sources of growth in total factor productivity. Their work suggests that periods of trade liberalization also tend to be

³See Helpman (1989) and Helpman and Krugman (1989) for a broad analysis of the many issues emerging under imperfect competition. See, too, Baumol and Lee (1991).

periods where total factor productivity growth is unusually high. Harrison (1991) and Salvatore and Hatcher (1991) discuss supportive evidence. The 1991 *World Development Report* (p. 100) shows for a large group of countries a positive association between trade liberalization and the residual in GDP growth after accounting for the growth in inputs. An aggressive trade opening may well qualify as a Schumpeterian change that triggers growth. As Schumpeter wrote (1934 [1983], pp. 64–66): “Development in our sense is a distinct phenomenon. . . . [I]t is spontaneous and discontinuous change in the channels of the flow, disturbance of equilibrium, which forever alters and displaces the equilibrium state previously existing. . . . Development in our sense then is defined by the carrying out of new combinations.”

In Schumpeter’s analysis, the discontinuity of events and opportunities is the critical ingredient in promoting a new growth environment, it is *change* that is the source of increased productivity. Such a discontinuity involves, specifically, the introduction of a new good; the introduction of a new method of production; the opening of a new market; the conquest of a new source of supply of raw materials or half-manufactured goods; and the carrying out of the new organization of any industry. Together, deregulation and trade reform can shake an economy out of a slow-growth trap, toward an acceleration of growth which then develops its own dynamics and financing. Of course, there is no basis here for a *sustained* increase in growth. Rather, the model suggests a temporary acceleration of growth that need not be sustained indefinitely but will have shifted the economy to a higher growth path.

The Schumpeterian model has substantial theoretical support. For example, firms may well have available better techniques and good ideas, but they are unwilling to implement them except in the favorable setting of economy-wide, major and irreversible change. Once a program of liberalization is put in place, adaptation must take place and that is the occasion to implement major productivity improvements that had been on the shelves. The coordinated response to the change both acts to trigger externalities and it assures thereby that a reversal becomes far less likely. High rates of investment and the associated increase in productivity are a natural by-product of a successful break away from a trapped slow growth economy. Trade liberalization is also a time when opportunities open up, because access to cheap inputs creates export opportunities, which carry rents and profits that can be invested in capital goods, which in turn yield further productivity gains. Although case studies of liberalization paint this picture, it is hard to capture in systematic measurements and cross-country comparisons.

It would be helpful at this stage to offer summary evidence on the proposition that outward orientation is beneficial, whatever the channels. But even though the case for these productivity gains is highly plausible, it has been hard to document in a clear-cut way. The comprehensive survey by Havrylishyn (1990) does identify systematic evidence in support of the theory, but it is not overwhelming. The most plausible evidence comes from case studies. The other

important source of quasi-evidence is the more novel work of modelling imperfectly competitive economies in computable general equilibrium models (for example, Norman, 1990). These models highlight that in specific market structures or with specific scale economies, the gains from liberalized trade can be substantial. In fact, in some examples the gains are far larger than the static resource reallocation affects and come to more than 10 percent of GNP.

Recently, a number of studies have tried to investigate the link between growth performance and trade regime. The hypothesis, in line with the arguments brought above, would suggest that more open economies experience higher growth. Of course, without a satisfactory single and internationally comparable measure of openness and with so many other critical factors, investigations of this hypothesis start with a major handicap. The difficulty, of course, is in standardizing for all the factors impinging on growth performance. Edwards (1991) investigates the link to growth performance of a broad range of indicators of openness proposed in the literature and concludes that the sum of the evidence (though few individual pieces) amounts to persuasive evidence of the beneficial effects of an outward trade orientation.

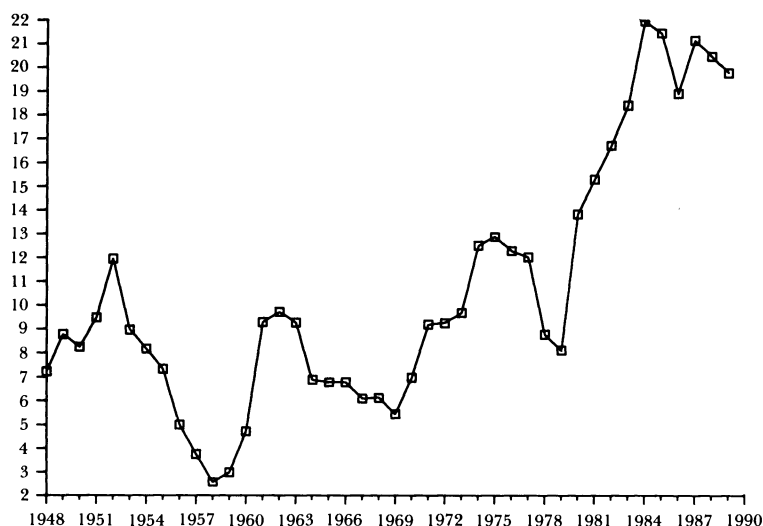
Three Examples: Turkey, Korea and Mexico

In this section we sketch three examples of trade liberalization from three different parts of the world: Turkey, Korea and Mexico.

Following an earlier attempt, Turkish liberalization took place in the early 1980s. Compared to Latin America, Turkey had come early to face a debt crisis. Growth based on borrowing from abroad had been strong, but when financing disappeared, an adjustment of the economy became necessary (Sareacoglu, 1987; Celasun and Rodrik, 1989; Michaely et al., 1991; Papageorgiou et al., 1990). In the 1980–84 period, quotas were substantially eliminated, the exchange rate was depreciated, and the foreign exchange regime was liberalized. By the classification of a comparative World Bank study, the Turkish program was “major, strong and sustained.”

The results of Turkish opening (and of accompanying domestic political and economic stabilization and reform) are altogether striking. Figure 1 shows the large increase in the import ratio, illustrating the radical change of trade orientation. During the late 1970s, Turkish imports had been growing about 2 percent per year, while exports were declining at 1 percent per year. But from 1979 to 1989, although Turkish imports grew by 10.4 percent per year, exports grew by 19.2 percent per year. Since overall growth in GDP was about 5 percent per year, this implies that trade became substantially more important to the Turkish economy. Interestingly, as Turkish imports and exports increases, manufacturing also grew from 22 percent of GDP in 1980 to 27 percent of GDP in 1989.

Figure 1
Turkey: Import / GNP Ratio
 (percent)



A second example is Korea, where trade reform occurred steadily in the 1970s. Here, the trade liberalization was selective. Major sectors of the economy were excluded, but the selection was accomplished in a manner that apparently did not interfere with productivity and growth. Korea made a point, in particular, of allowing capital goods and intermediate goods to be imported. For example, automobile engines were first imported, then produced under licence and now under Korean design. By 1983, of some 10,000 product classes, 19.6 percent still contained import restrictions. By 1989 the fraction had declined to only 5.3 percent and most of these were primary commodities. Only 46 industrial products continue with import licensing or prohibition. The average tariff has been brought down from 24 percent to 11 percent for industrial products with the prospect under a new tariff law to lower them to 5 percent by 1993 (Young, 1989).

Even though Korea liberalized only selectively, liberalization did take place. Korea's non-oil import/GDP ratio back in 1960 was less than 10 percent, similar to the figure today in Brazil or Argentina. But since 1975 or so, the figure has been in excess of 25 percent. With the help of a selectively liberal import strategy, Korea has been able to develop a highly competitive manufacturing sector that offers its own brand-name manufactures of increasing sophistication, ranging from cars to TV and now high technology goods. Interestingly, even though trade had been substantially liberalized in the 1980s, of the 12 percent import ratio for finished manufacturing, 1.3 percent was in

Table 2
Mexican Trade Restrictions
(percent)

	1982	1990
Import License Coverage	100.0	14.1
Tariff Categories	16	5
Maximum Tariff	100.0	20.0
Average Tariff	27.0	13.1
Weighted Average Tariff	16.4	10.4

Source: USITC (1990) and Banco de Mexico

consumer goods. Thus, liberalization was conspicuously concentrated on capital goods.

A third example of liberalization is Mexico. Until 1985 Mexico was totally protected: tariffs, quotas on top and licences in addition, just in case. Table 2 gives an impression of the closeness of the Mexican economy. The result was a very poor productivity performance and an extraordinary degree of monopoly, which was strongly reinforced by domestic restrictions on entry and external restrictions on direct investment.

Starting in 1985, the economy was opened. The scheme first envisaged was a gradual opening, but as political pressures for delays and exemptions built up, the Mexican administration reacted by pushing ahead the timetable and opening radically. Although some areas like chemicals and automobiles have been substantially exempted so far, a great deal of liberalization has been accomplished. Import penetration increased already from an average of 11.3 percent in 1980–85 to 14.5 in 1986–90. By 1990 import penetration had already reached 17 percent. This sharp growth in imports, unaccompanied by an offsetting immediate gain in exports, gave rise to the free trade initiative with the United States which now is under discussion.

In the three countries considered here, the trade liberalization strategy is not being questioned. Trade liberalization was part of a wider strategy of achieving stability and efficient resource allocation. As such, modernization and growth (and the resulting seeds for improved welfare) cannot be attributed uniquely to the trade strategy. But liberalized trade has so fundamentally shaken up the production structure, that more liberal trade is invariably credited with a good share of the performance. In Mexico's case, for example, output growth by 1989–90 was rising to above 4 percent, far exceeding the levels of the past five years. Even if there is no direct measure of the success of liberalization, indirect support comes from the fact that rolling back trade liberalization is simply not on the economic or political agenda.

What Remains of the Case for Protection?

The case for protection rests on one of two pillars: externalities or learning effects. Externalities are, of course, the last recourse of scoundrels; they are invariably invoked as the case for intervention even though documenting them (as opposed to modelling them) is notoriously difficult. Externalities associated with a protection strategy would arise if the physical capital formation associated with industrialization or the formation of human capital carries spillover effects, pecuniary or real, that cannot be appropriated by the individual firm and industry. Learning-by-doing as an argument for protection, by contrast, does not rely on externalities but rather on capital market imperfections that make firms reluctant to engage in the development of the productivity bonus even though from the social point of view it is warranted. Labor market imperfections may also stand in the way of a warranted industrialization if the training of labor that yields the productivity benefits cannot be captured by the investing firm and cannot be borne (for capital market or information reasons) by the workers who will be vested with the benefits. In either case, it is clear that protection is never the first-best strategy. Targeted subsidies are always better, although considerations of feasibility and political economy will always be brought in favor of protection.

Against the massive evidence that small countries will wither behind protective barriers, there is some evidence that protection can also yield success. Korea, Brazil and Japan would be the parade cases. These countries are among those with the highest growth rates of GDP and total factor productivity in the 1965–80 period and none of them is a free trader. Brazilian growth averaged 7.7 percent over the period and that of Korea was 6.7 percent per year; industry grew at 10 and 16 percent per year respectively.

Essential ingredients of the strong performance were three. First, that exchange rate policy was carefully designed to avoid overvaluation and with it macroeconomic bottlenecks. Second, that external credit played a key role as did foreign investment and foreign technology. Third, that the trade regime was sufficiently selective so that intermediate goods and capital goods were not excluded. Care was taken in particular not to tax exports implicitly.

Even though we portray the experience as a success, the interpretation might be open to challenge. Brazil did crash in the 1980s and is now seeking trade liberalization as a means to growth. In Korea, the massive investment in the heavy industry was seen in the early 1980s as a major blunder. Today, with lower oil prices, even that judgment is no longer true. While the discussion remains open, the fact is that under the cover of significant (though porous) protection both countries developed in the 1960s and '70s a world-class manufacturing sector. It remains to discern exactly what makes the difference between an Argentine experience where protection was a disaster and these very positive cases.

It is perhaps the experience of Korea and Brazil where industrialization under the cover of protection led ultimately to highly competitive export industries that accounts for the interest in the export sector as an engine of growth and the locus of government intervention. One direction is to focus on targeted liberalization that does not interfere with the nurturing of infant industries; infants have to grow up at home, they cannot start off as exporters. Another is to shift the focus to export strategies. For example, de Melo and Robinson (1990) develop a model of such a process and find that export externalities, in a computable general equilibrium model calibrated to the typical developing country experiencing export-led growth, that policies that support export externalities yield significant growth effects.⁴

The potential gains from liberalization strategy and the successful nurturing of infant industries by selective protection and subsequent export policies must be qualified in one important dimension. If developing countries as a group open up, there is every reason to believe that their terms of trade will be adversely affected. Flooding the world market with their manufactures, while their market access to industrialized countries remains the same, cannot fail to reduce the prices at which they will export (Faini et al., 1990). But for the individual country, that is not a reason to shy away from liberalization. Even for developing countries as a group, the benefits from the various sources discussed above are likely to outweigh substantially the costs of worsened terms of trade.

Even when there is a case for protection, the Korean experience suggests that the strategy works best when used selectively. In this manner the country will not devote resources to accomplishing the impossible and as a result lower productivity economy-wide. Rather, selective protection (even on a wide basis) serves to capture the learning benefits while minimizing the resource cost. That involves inevitably guessing where the areas of learning and externalities are likely to lie, it involves the risk of double-guessing markets, and it often fails. But in Korea and a handful of other cases, it has helped improve growth or at the least it seems to have done no harm to a stellar performance.

What Can Go Wrong?

One problem for trade reform is political. Too long a phase-in period with too many safeguards for those who might be adversely affected is an invitation to disruption and reversal. The other risk comes from the exchange rate. The elimination of obstacles to trade invariably creates an immediate increase in

⁴Going beyond liberalization, de Melo and Robinson (1990, pp. 30–31) conclude: “If there are externalities to be exploited, policy makers should pursue them aggressively and not worry overmuch about getting the instruments just right. . . . [W]hen there are rectangles to be gained, an economy can easily afford some triangles along the way.”

imports. But although inputs become more readily available and technology improves, the beneficial rise in exports does not happen immediately, even if a real depreciation is undertaken. For example, when Chile first liberalized imports almost fully in the late 1970s (but overvalued its managed exchange rate) import levels exploded and the exchange rate collapsed. Another stabilization had to be undertaken. Without a real depreciation, exports will scarcely help pay for the higher imports.

Because of balance of payments problems, comprehensive trade reform requires one of two conditions: either the country must be politically in a position to have a major real depreciation of the exchange rate (to help boost exports) or else it must have access to foreign exchange for a substantial period of time. Real depreciation is a problem because it means a fall in real wages unless offset by the improvement in the standard of living that stems from reduced protection. If reserves are not available and depreciation is impractical, the only realistic option for trade policy is to approach liberalization more gradually.

A gradual path to trade liberalization should occur in two steps. In a first round, the country should move from quotas and licences and other nontariff barriers to a uniform, high tariff of (say) 50 percent. Later, as the economy grows and the external balance can support liberalization without the risk of a foreign exchange crisis, tariffs can be taken down to (say) 10 percent. This more moderate policy still opens the economy, because even tariffs at high rates allow competition at the margin, while quotas and licenses are there to prevent it. But at the same time it avoids the grave risk of an exchange crisis.

A drastic example of liberalization at the wrong exchange rate comes from the recent unification of Germany. Prior to unification East Germany had traded mostly with the Soviet Union, and little with nonsocialist economies. When consumers faced unification and free trade with West Germany, they turned overnight from domestic goods toward West German merchandise. In economies left out of world progress, "opening up" translates into a situation where domestic goods become lemons that cannot be sold virtually at any price. The result in East Germany was a decline of industrial production of 50 percent and, for a time, mass unemployment. Joint ventures and western brand names on improved eastern products are seen as the answer.

Of course, the East German experience is special in that the exchange rate conversion made West German goods expensive, but not astronomically so. However, even in a situation where exchange rates are set so that foreign goods are clearly far more expensive than domestic brands, say by a factor of two or three, rapid and pervasive import penetration is likely to occur. Liberalization in Chile and Mexico has made that clear.

The East German experience will be repeated, although on a lesser scale, as other countries open up, whether in Eastern Europe or in the third world. One response is to try and avoid such disruptions by continuing protectionism or traditional trade agreements. But the right answer is to recognize that the

adjustment ought to happen, because consumers and producers do want better and more varied goods. Countries should bite the bullet by adopting highly competitive exchange rates, even if that means that imports are relatively quite expensive. Only when there is massive support from abroad and coordinated direct investment (as in the case of East and West Germany) can there be an expectation of avoiding a sharp real depreciation.

New Directions in Trade Strategy

In concluding this essay, we draw attention briefly to two new directions in trade strategy: service trade liberalization and regional free trade agreements.

Most of the discussion of trade liberalization in the past has focused on merchandise trade and until recently almost no attention and certainly no empirical work has paid attention to trade in services. The Uruguay Round of trade negotiations now underway changes that. Trade in services is a major issue for developed countries who see themselves as exporters, but also for developing countries who expect some export opportunities, but also recognize the role of services in promoting productivity.

Most of the recent attention has focused on financial services (banking, underwriting, insurance) where there are obvious gains from scale economies and competition. Financial markets in developing countries (and in Europe) operate far less competitively and with far larger spreads and fees than in the United States. Hence the case for liberalizing financial service trade. But the interest in service trade liberalization extends to other areas: accounting, consulting, legal services, construction planning, design, telecommunications and others. It is clear that the case for liberalized trade in services is no different from that for trade in merchandise. The fact that services have not been much traded in the past draws attention to a stark omission in the traditional assessments of the cost of protection.

The second new direction is even more sweeping: developing countries are looking for free trade arrangements with developed countries. Previously, the issue of market access and preferential access to the markets of developed countries had been a chief item on the agenda of UNCTAD. The General System of Preferences, under which industrial countries gave developing countries privileged market access for a broad range of goods, was a way of implementing that objective. What is new is the willingness to practice free trade as a two-way street. Mexico has taken that route in asking for free trade negotiations with the United States and Canada and, following an acrimonious debate before the U.S. Congress, negotiations are now under way. The United States may take the NAFTA (North American Free Trade Agreement) as a blueprint to allow other countries to adhere on a conditional most-favored-nation basis. If that turns out to be the case, the Americas may become a free trade area in the next decade or two.

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